



***FINANCIAL SECTION
AUDITOR'S REPORTS***

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UNITED STATES RAILROAD RETIREMENT BOARD

OFFICE OF INSPECTOR GENERAL

To the Board Members:

The following report presents the results of the Office of Inspector General's (OIG) audits of the financial statements of the Railroad Retirement Board (RRB) as of and for the fiscal years ended September 30, 2006 and 2005.

OPINION ON THE FINANCIAL STATEMENTS

We have audited the accompanying balance sheet of the RRB as of September 30, 2006 and 2005, and the related statements of net cost, changes in net position, financing, and budgetary resources for the years then ended; and the statement of social insurance as of January 1, 2006.

We did not audit the financial statements of the National Railroad Retirement Investment Trust (NRRIT). The net assets of the NRRIT represent approximately 85% and 84% of the total assets reported by the RRB for fiscal years 2006 and 2005, respectively; and 96% of the reported railroad retirement program fund balance as of January 1, 2006. Related changes in the net value of investments held by the NRRIT represent approximately 15% and 22% of the financing sources reported by the RRB for fiscal years 2006 and 2005, respectively.

Pursuant to the Railroad Retirement and Survivors' Improvement Act of 2001, the NRRIT retains the services of an independent auditor to opine on its financial statements. With respect to the assets of the NRRIT as of September 30, 2005, September 30, 2006, and January 1, 2006, the financial statements of the NRRIT were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for the NRRIT, is based solely on the report of the other auditors.

In our opinion, the financial statements referred to above, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, the financial position of the RRB, its consolidated net cost of operations and changes in net position, combined budgetary resources, and reconciliation of net cost to budgetary resources as of and for the fiscal years ended September 30, 2006 and 2005; and the financial condition of the railroad retirement program as of January 1, 2006.

As described in the statement and related notes, the statement of social insurance presents the actuarial present value of the future income to be received, and expenditures to be paid to or on behalf of participants in the railroad retirement

program during a period sufficient to illustrate the program's long-term sustainability. In preparing the statement of social insurance, management considers and selects assumptions and data that it believes provide a reasonable basis for the assertions in the statement. However, because of the large number of factors that effect the statement of social insurance and the fact that future events and circumstances cannot be known with certainty, there will be differences between the estimates in the statement of social insurance and the actual results, and those differences may be material.

Emphasis of Matters

Transfers-in from the Social Security Administration's Old-Age and Survivors Insurance and Disability Insurance trust funds and transfers-out to the Federal Health Insurance trust fund represented approximately \$3.3 billion (net), or approximately 28%, of the nearly \$11.5 billion in total financing sources reported on the statement of changes in net position for FY 2006.

The RRB's FY 2005 balance sheet has been restated to include the net value of railroad retirement program assets held and invested by the NRRIT which amount to approximately \$27.7 billion dollars. These investments were previously excluded from the RRB's financial statements. The statement of changes in net position has been restated to include the \$2.6 billion change in the value of NRRIT net assets as a financing source which also increased "Resources that Finance the Acquisition of Assets" on the statement of financing by the same amount.

The RRB's FY 2005 statement of changes in net position has been restated to report approximately \$97.2 million in contributions collected for the railroad unemployment insurance program as non-exchange revenue. Previously, this financing source had been reported as transfers-in without reimbursement.

RRB management discloses the aforementioned restatements in Note 18 to the financial statements.

The OIG rendered an unqualified opinion on the RRB's FY 2005 financial statements. The aforementioned restatements would not have altered that opinion except to the extent that the previous opinion included an emphasis of matters alerting readers that assets held by the NRRIT and related income had not been reported in the RRB's financial statements.

REPORT ON INTERNAL CONTROL

Our evaluation of internal controls disclosed three material weaknesses and two reportable conditions.¹ The details of our findings follow. However, the objective of our audit was not to provide an opinion on internal control. Accordingly, we do not express such an opinion.

Although not considered to be material weaknesses or reportable conditions, we will report other matters involving internal control and its operation to RRB management in a separate letter.

Material Weaknesses

Information Security

During FY 2006, the OIG evaluated information security pursuant to the provisions of the Federal Information Security Management Act.² Our review disclosed continued weaknesses in many areas of the RRB's information security program. Significant deficiencies in program management and access controls make the agency's information security program a source of material weakness in internal control.

The RRB has undertaken the job of strengthening information security and has implemented many corrective actions recommended by the OIG and other technical specialists. During FY 2006, the agency completed corrective action to eliminate the previously reported significant deficiency in training. Previously identified significant deficiencies in access controls, risk assessments, and periodic testing and evaluation continue to exist, as well as other observed weaknesses in the agency's implementation of requirements for risk based policies and procedures, a remedial action process, continuity of operations, and inventory of systems.

The agency is addressing their significant deficiencies in the previously reported areas of access controls, risk assessments, and periodic testing and evaluation; however, much work remains to be completed.

¹ Material weaknesses in internal control are reportable conditions in which the design or operation of the internal control does not reduce to a relatively low level the risk that errors, fraud or noncompliance in amounts that would be material in relation to the Basic Statements or Required Supplementary Stewardship Information being audited, or material to a performance measure or aggregation of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Reportable Conditions are matters coming to the auditor's attention that, in the auditor's judgment, should be communicated because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to meet the objectives of internal control.

² "Fiscal Year 2006 Evaluation of Information Security at the Railroad Retirement Board," OIG Report #06-11, September 27, 2006

Performance Measures

During FY 2005, the OIG identified a material weakness in internal control over the preparation and reporting of performance information due to inadequacies in the review and validation of data. Although management has made progress in addressing this weakness, the agency has not yet fully implemented planned corrective action.

During FY 2006, the Office of Programs, the organizational unit responsible for reporting on the largest number of complex statistically based indicators, implemented new controls over the preparation, review and approval of performance data originating in that organization. In October 2006, the three-member Board approved an administrative circular establishing standards and assigning responsibility for collecting, documenting, validating, certifying, reporting and retaining performance information.

Although procedural changes have been formally approved, those changes have not been fully implemented and agency management has not yet operated under these procedures during a period sufficient to evaluate their effectiveness.

Actuarial Projection Process

The RRB needs to strengthen controls over the actuarial projection process that supports the projections and estimates presented in the statement of social insurance, in the notes to the financial statements and as required supplementary information.

During FY 2005, the OIG performed a detailed evaluation of controls over the actuarial projection process that disclosed inadequacies in internal control over the projection process and related reports.³ Although responsible management and staff had described extensive controls over the preparation of projections, estimates and reports, they had not formalized their policies and procedures, did not capture evidence of the operation of controls and did not perform periodic evaluations of compliance with internal requirements.

During FY 2006, the Bureau of the Actuary responded to the OIG's findings by documenting their internal control structure through the RRB's management control review process. This process included development of an updated chart of controls and a bureau-level assessment of the operation of those controls.

³ "Review of Internal Control Over the Actuarial Projection Process," OIG Report #05-04, May 5, 2005

Corrective action taken during FY 2006 represents significant progress but management has not yet published formal policies and procedures, developed documentation to support the actuarial model or implemented a formal quality assurance process. These deficiencies were cited in the OIG's FY 2005 evaluation.

Reportable Conditions

Prompt Payment Act

As a result of an FY 2005 evaluation of controls over compliance with the Prompt Payment Act, the OIG reported that existing systems and procedures had not been effective in ensuring that interest is paid to vendors in accordance with the requirements of the law.⁴ At that time, we observed that the RRB did not identify all invoices on which interest should be paid, did not pay the correct amount of interest when a late payment was recognized, and that controls were not adequate to ensure that required restrictions on early payment had been properly implemented.

During FY 2006, the Bureau of Fiscal Operations made substantial progress in correcting the deficiencies in both controls and compliance. However, most changes were implemented more than six months into the fiscal year and have not been tested by the full range of payment experience. In addition, we have observed that management has not yet ensured the level of uniform processing accuracy that would permit the OIG to conclude that the action taken has been fully effective.

Financial Reporting

Over the years agency responsibility for financial reporting has grown from preparation of financial statements within six months of fiscal year-end, to publication of an annual performance and accountability report within 45 days of fiscal year-end. Publication of that report is an exercise in public accountability of which preparation of accurate, reliable financial statements is but a single part.

The Bureau of Fiscal Operations is responsible for publishing the RRB's annual performance and accountability report. That organization has documented procedures and controls over its financial reporting process. During our audit we observed that existing procedures and controls need to be updated to fully ensure the quality of the RRB's response to the expanding responsibilities and short timeframes that are inherent to the reporting process. We also observed that the existing control framework is over-reliant on the OIG's annual audit of the financial statements to ensure the completeness and accuracy of the performance and accountability report.

⁴ "Review of Compliance with the Prompt Payment Act," OIG Report #05-06, June 15, 2005

The OIG and the Bureau of Fiscal Operations have already begun discussing ways to strengthen the existing control framework.

COMPLIANCE WITH LAWS AND REGULATIONS

Our tests of compliance with selected provisions of laws and regulations disclosed one instance of non-compliance that is reportable under U.S. generally accepted government auditing standards or Office of Management and Budget (OMB) guidance as described below.

The RRB has not fully complied with the Prompt Payment Act. During FY 2006, the RRB made substantial progress in correcting the previously identified deficiencies in both controls and compliance; however, most changes were implemented more than six months into the fiscal year and have not been tested by the full range of payment experience. In addition, we have observed that management has not yet ensured the level of uniform processing accuracy that would permit the OIG to conclude that the action taken to date is sufficient to ensure substantial compliance with the Act.

The results of our tests of compliance disclosed no other instances of noncompliance with laws and regulations that are required to be reported under government auditing standards or OMB guidance. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

CONSISTENCY OF OTHER INFORMATION

The RRB's Management's Discussion and Analysis, required supplementary information, and other accompanying information contain a wide range of data, some of which are not directly related to the financial statements. We did not audit and do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with RRB officials. Based on this limited work, we found no material inconsistencies with the financial statements or nonconformance with OMB guidance except for the weakness in internal control over performance measurement that limits the reliability of the agency's reporting under the Government Performance and Results Act (GPRA) which is discussed in the internal control section of this report.

OBJECTIVES, SCOPE, AND METHODOLOGY

RRB management is responsible for (1) preparing the annual financial statements in conformity with U.S. generally accepted accounting principles, (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act (FMFIA) are met, and (3) complying with applicable laws and regulations.

We are responsible for obtaining reasonable assurance about whether (1) the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles and (2) management maintained effective internal control that provides reasonable, but not absolute, assurance that the following objectives were met.

- Financial reporting: transactions are properly recorded, processed and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles and assets are safeguarded against loss from unauthorized acquisition, use or disposition.
- Compliance with laws and regulations: transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and governmentwide policies identified by OMB audit guidance.

We are also responsible for (1) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, and (2) performing limited procedures with respect to certain other information appearing in these annual financial statements. In order to fulfill these responsibilities, we:

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall presentation of the financial statements;
- obtained an understanding of internal controls related to financial reporting and compliance with laws and regulations;
- obtained an understanding of the recording, processing, and summarizing of performance measures as reported in Management's Discussion and Analysis;

- tested relevant internal controls over financial reporting and compliance, and evaluated the design and operating effectiveness of internal controls;
- considered the process for evaluating internal controls and financial management systems under the FMFIA;
- tested compliance with selected provisions of the following laws and regulations:
 - Anti-Deficiency Act, as amended,
 - Prompt Payment Act,
 - Pay and Allowance System for Civilian Employees,
 - Provisions Governing Claims of the United States Government including provisions of the Debt Collection Improvement Act,
 - laws providing for the appropriation of funds for the administration of the programs mandated by the Railroad Retirement and the Railroad Unemployment Insurance Acts, including the payment of benefits, and
 - Railroad Retirement and Railroad Unemployment Insurance Acts.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FMFIA, such as controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to controls over financial reporting and compliance. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected. We also caution that projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate.

We did not test compliance with all laws and regulations applicable to the RRB. We limited our tests of compliance to those laws and regulations that had a direct and material effect on the RRB's financial statements or that were required to be tested by OMB audit guidance that we deemed applicable to the financial statements for the fiscal years ended September 30, 2006, and 2005. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

The NRRIT was established pursuant to the Railroad Retirement and Survivors' Improvement Act of 2001 (Public Law 107-90). Under that law, the NRRIT is not a department, agency or instrumentality of the Government of the United States. In addition, the law specifically exempts the NRRIT from compliance with Title 31, United States Code which governs the monetary and financial operations of the Federal government. The law also provides that the NRRIT annually engage

an independent qualified public accountant to audit the financial statements of the Trust. Accordingly, the OIG has not audited the books and records of the NRRIT nor had any input into the selection of the independent accountant retained by the NRRIT, nor provided oversight to that firm in the execution of their responsibilities. Our opinion on the RRB's financial statements, insofar as it relates to the amounts included for the NRRIT, is based solely on the report of the auditor retained by the NRRIT and our assessments of internal control and compliance do not extend to the operations of the NRRIT.

Except to the extent that the foregoing arrangement may have affected the planning and execution of our audit, we performed our work in accordance with U.S. generally accepted government auditing standards and OMB audit guidance.

RRB MANAGEMENT'S COMMENTS

The Chief Financial Officer and the Board Members have reviewed the draft report. In their reply, they thank OIG management and staff for working closely and cooperatively with agency personnel to ensure that the agency would be able to meet the November 15th reporting deadline.

Management did not comment directly on the three material weaknesses reported by the OIG noting that their comments on these issues were included in their published response to the serious management challenges identified by the OIG which are presented separately in the "Other Accompanying Information" section of the RRB's Performance and Accountability Report. In response to the reportable conditions cited in the audit report, management states that they are taking corrective action to ensure compliance with the Prompt Payment Act and will continue to refine their procedures to meet the expanded responsibilities and shortened timeframes for financial reporting.

The full text of management's response follows as an attachment to this report.



Martin J. Dickman
Inspector General

November 3, 2006, except for matters relating to the fair market value of the net assets of the NRRIT as of September 30, 2006, (see Note 5 to the financial statements), as to which the date is November 15, 2006.



UNITED STATES GOVERNMENT
MEMORANDUM

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FORM G-1151 (1-92)
RAILROAD RETIREMENT BOARD

NOV 09 2006

TO : Henrietta B. Shaw
Assistant Inspector General, Audit

FROM : Kenneth P. Boehne
Chief Financial Officer *Kenneth P. Boehne*

SUBJECT: FY 2006 Financial Statement Audit – Auditor’s Report;
Re: Your memorandum dated November 7, 2006

My office, and those of the Board Members, have reviewed your draft report and have the following comments.

You reported material weaknesses in the Railroad Retirement Board’s information security program, performance measurement program and actuarial projection process. Our comments on these areas of concern are included on page 100 of the fiscal year 2006 Performance and Accountability Report as part of our response to your report on the serious management challenges you believe face the RRB. Regarding other matters presented in your draft audit report, we are taking action to ensure compliance with the Prompt Payment Act and will continue to refine our procedures to meet the expanded responsibilities and shortened timeframes for financial reporting.

We again thank you and your staff for working closely and cooperatively with us these past few months to ensure that the RRB was able to meet this year’s reporting deadline of November 15.

cc: The Board
Executive Committee